



# INDIA DEMONETIZES CURRENCY AFTER 36 YEARS: REVIEW

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## ABSTRACT

Demonetization is an economic term which is used to mean the 'scrapping' of old currency notes and stripping them off their status of legal tender, usually when a new currency note or currency is being introduced in the economy of the country. This is a standard practice followed by all major economies of the world for different reasons. For instance, when the 'Euro' was introduced as the common currency of the European Union, the participating countries had effectively followed a 'demonetization' drive of their respective currencies by fixing exchange rates for the old currency to the newly introduced Euro. Indian Rupee has been demonetized various times as well. The Rs. 10,000 notes were demonetized once in January 1946 and then again in January 1978. Recently, the Rs. 500 and Rs. 1000 notes were demonetized in a surprise move on November 8, 2016. The recent scrapping of Indian 500 and 1000 rupee currency notes has sent the entire country in a whirlpool of confusion. The country may be happy about the initiative or upset with the move, but the word 'demonetization' has recently become the trend. We bring to you the basic understanding of what the word means, when and how the demonetization of Indian Currency was brought into effect and why it is good or bad.

**KEYWORDS:** currency, exchange rate, growth.

## INTRODUCTION

India's central bank, the Reserve Bank of India, came out with a surprise announcement that it will withdraw all banknotes printed before 2005 at the end of March 31, 2014. This is what the bank said: "The Reserve Bank has also clarified that the notes issued before 2005 will continue to be legal tender. This would mean that banks are required to exchange the notes for their customers as well as for non-customers. From July 1, 2014, however, to exchange more than 10 pieces of Rs 500 and Rs 1,000 notes, non-customers will have to furnish proof of identity and residence to the bank branch in which she/he wants to exchange the notes.

This is not the first time this has happened in India, at least technically. Earlier, Rs 1,000 and Rs 10,000 banknotes, which were in circulation, were demonetized in January 1946, primarily to curb unaccounted money. The higher denomination banknotes in Rs 1,000, Rs 5,000 and Rs 10,000 were reintroduced in the year 1954, and these banknotes (Rs 1,000, Rs 5,000 and Rs 10,000) were again demonetized in January 1978. So that makes it the last time demonetisation was done in India. Almost 36 years ago.

Demonetization, as explained by Investopedia, is the act of stripping a currency unit of its status as legal tender. Demonetization is necessary whenever there is a change of national currency. The old unit of currency must be retired and replaced with a new currency unit. The creation of a single currency for the European Union over 1998-2000 was of course the largest demonetization and currency issue exercise, perhaps in history.

Times of India report (sourced in-house) published on 17th January 1978 said: "A press note issued tonight said that the ordinance had been promulgated because there was reason to think that high-denomination notes were facilitating the illegal transfer of money for financing transactions which are harmful to the national economy or which are for illegal purposes. There has been concern in recent months over the behaviour of agricultural prices particularly of edible oils. In spite of a bumper harvest agricultural prices are ruling much higher than after the poor harvest of 1976-77. Massive imports of edible oil have failed to bring down prices and the mustard oil price control order has failed miserably to give the consumer his requirements at the specified rate. There has been a feeling that a considerable amount of black money has gone to finance hoarding and speculation. The demonetization of high denomination currency notes will hit black money hard."

### Demonetization scenario: 12 Jan 1946 (Saturday) and 16 Jan 1978 (Monday) (Source: RBI History 1935-51)

There is very less relevant data available pertaining to the demonetization of 1946. Coming to the second demonetization which took place in 1978. The Morarji Desai Government took a decision to demonetize the Rs 1000, 5000 and Rs 10,000 notes. It was a step taken by the Janata Party Government to attack the illegal assets of the "earlier government". The method used by the Government to implement this decision was through an Ordinance which was later on converted into a special legislation. The govt came out with 2 ordinances on 12 Jan 1946, which was declared a holiday. First ordinance asked banks to furnish info about currency holdings of various denominations (Rs.100, Rs. 500, Rs. 1,000 and Rs.10,000). Second was about telling public that denominations of Rs. 500

and above were demonized. Rs 100 was spared.

People were given 10 days for exchange which meant first helpline ended at 23 Jan. This was later extended to 9 Feb where people had to give explanations on why they could not in first ten days. This time on one hand we are taking away old notes of Rs 500 and Rs 1000 but exchanging them with Rs 500 and Rs 2000 (with new Rs 1000 to come in later). So, it is a straight forward conversion if one looks at just the basics. Though, this time as far more number of people hold Rs 500 and Rs 1000 and many in unaccounted, it will have to be seen how many are returned. The lesser the conversion more it will become a case of demon.

This is strange if one looks at it. In 1946, the idea was to demon but it became more of a conversion. In 2016, we are calling it demon but it is actually conversion. However, lesser the conversion, it but could become demon. Talk about going in circles with words.

### SECOND — 16 JAN 1978 (SOURCE: RBI History 1967-81)

The Finance Minister H.M. Patel in his budget speech on 28 Feb 1978 remarked: "THE DEMONETISATION OF HIGH DENOMINATION BANK NOTES WAS A STEP PRIMARILY AIMED AT CONTROLLING ILLEGAL TRANSACTIONS. IT IS A PART OF A SERIES OF MEASURES WHICH GOVERNMENT HAS TAKEN AND IS DETERMINED TO TAKE AGAINST ANTI-SOCIAL ELEMENTS".

- The Central Board of Direct Taxes in its report titled, 'Measure to tackle Black Money in India and Abroad', have observed that in both instances of demonetization, in 1946 and 1978, less than 15% of high currency notes were exchanged, while over 85% of the currency notes never surfaced, as the owners feared penal action by central agencies.
- The value of high denomination notes in circulation 1978 was a mere Rs 130 crores – unlike the present situation where the value of high denomination notes in circulation is Rs 14.18 lakh crore or 84% of the value of all notes in circulation.
- That implies that most of the people at that time did not had the notes of bigger denomination. The higher denomination notes were only 15% of the total currency at that relevant time (1978).
- This time, the higher denomination notes constitute a sizable part i.e. almost 80–85% of the total existing currency. Therefore, this has resulted into massive churning of the economic system considering the magnitude of the notes which are demonetized.
- Another reason of the failure of the 1978 demonetization was the public nature of the recommendation of the Wanchoo Committee. A committee constituted in 1970 had recommended demonetization and after that there was periodic discussion considering the implementation of the decision. This alerted the black money holders and gave them ample of time to get rid of their hoarded assets resulting into ineffectiveness of the decision.
- Learning from the loopholes in the decision of the earlier government of

1978, the Modi Government maintained absolute secrecy of their planning in pursuant to the demonetization scheme.

- In the earlier editions. RBI was mostly against the exercise, but this time the recommendation of demonetization is from the Central Board of Directors of the RBI.
- The big difference is the magnitude and volume of money involved this time. Previous ones barely impacted common people but this one is huge with 85% of currency out of the system. So this time it is a massive filtering of the currency system.
- Further, the problem of the counterfeit notes was not that prevalent at that time as compared to the existing scenario. Therefore, the current decision has impacted the counterfeit and duplicate notes on a larger scale.

- In order for every demonetization move to succeed, there must be additional further steps like strict implementation of taxes and action against the benami properties. The Hon'ble Prime Minister in his recent speech has already hinted action against the benami properties and transactions. Further, strong measures in tax laws are also anticipated.
- The Government is also planning to limit cash transfers which shall be a step towards cashless transactions. Cash Transactions are the major reason for tax evasions and hoarding of black money. The Government must put a tab on the cash transfers and make mandatory the use of cashless transaction which will involve banks resulting into detailed scrutiny of the transactions. Having said that, the tax deducted while doing cashless transactions must be reduced by a certain extent which will result into more people opting for cashless transactions. Arun Jaitley has already disclosed the intentions of the government for bringing these measure. Such kind of means were not available at the time of 1978 government.

In Rs crore	Notes and Coins below Rs 10	Rs.10 Notes	Rs.20 Notes	Rs.50 Notes	Rs.100 Notes	Rs. 1000 Notes	Rs. 5000 Notes	Rs. 10000 Notes	Total
1977-78	1285	1825	690	995	4302	55	17.97	0.11	9170.1
1978-79	1325	1957	779	1440	5369				10870.0
Difference	40	132	89	445	1067				1699.92

So, around 73.1 crore was the demonetised amount (Rs 1000 + 5000 + 10000) in 1977-78. Compared to this, 1067 crores were added by Rs 100 alone and the rest of the smaller denoms made up another 650 crores. So, it did not destroy any money stock at all. In 1946, atleast some bit was destroyed. The amount of denoms were also much smaller than seen in 1946 (which is a puzzle!).

This was because Rs 10,000 was barely used. Its volumes were also highly volatile dipping to lows and then rising a bit. This was because of rumors that the currency is going to be demoned:

Year	Rs.1000 Notes	Rs.5000 Notes	Rs.10000 Notes	Total High Denom	Total Currecny in Circ	HD as % of total Currency
1970-71	45.0	21.5	1.0	67.5	4596.0	1.5
1972-73	43.0	19.1	10.3	72.3	5742.3	1.3
1973-74	35.0	25.1	26.0	86.1	6676.1	1.3
1974-75	35.0	23.8	21.6	80.4	6776.4	1.2
1975-76	88.0	22.9	1.3	112.2	7120.0	1.6
1976-77	105.0	18.3	23.9	147.2	8354.3	1.8
1977-78	55.0	18.0	0.1	73.1	9170.1	0.8

IF DEMONETISATION OF 1946 AND 1978 FAILED, WHY WILL THE DEMONETISATION SUCCESSED? ONLY TIME WILL TELL....

There are both parallels and differences with 2016 episode.

- Similarities are all three were aimed at curbing black money. Though this time security is an added challenge.
- In the earlier editions. RBI was mostly against the exercise and was proven right. This time it seems RBI has welcomed the idea (though there could be initial differences which will emerge only later). So, will RBI be proven right or wrong given their current view?
- The big difference obviously is the size this time. Previous ones barely impacted common people but this one is huge with 85% of currency out of the system.
- The first demonetization was a case of conversion. Second of cumulation. Third is projected as a demon but is more of a conversion. Will it be a case of demon? Only time will tell...